RLPPC Enhanced Buy and Maintain Credit Fund

Quarterly Report 31 March 2022

Asset split

	Fund (%)
Conventional credit bonds[1]	99.9
Index linked credit bonds	0.0
Sterling conventional gilts	0.0
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.1
Foreign index linked sovereign	0.0
Derivatives	0.0

Fund data

	Fund
Duration[2]	8.1 years
Gross redemption yield[3]	3.16%
No. of stocks	467
Fund size	£368.2m
Spread	1.55%

Source: RLAM. Launch date: 16.01.2017.
[1]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.
[2]Excluding cash
[3]The gross redemption yield is calculated on a weighted average basis.
Figures in relation to the asset spilt table exclude the impact of cash where held.
Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%) (Income)	Reference index[1] (%)
Q1 2022	**-6.23**	**-6.19**
Year-to-date	-6.23	-6.19
Rolling 12 months	-3.65	-5.20
3 years p.a.	1.82	0.96
5 years p.a	2.37	1.55
Since inception p.a. 16.01.2017	2.84	1.94

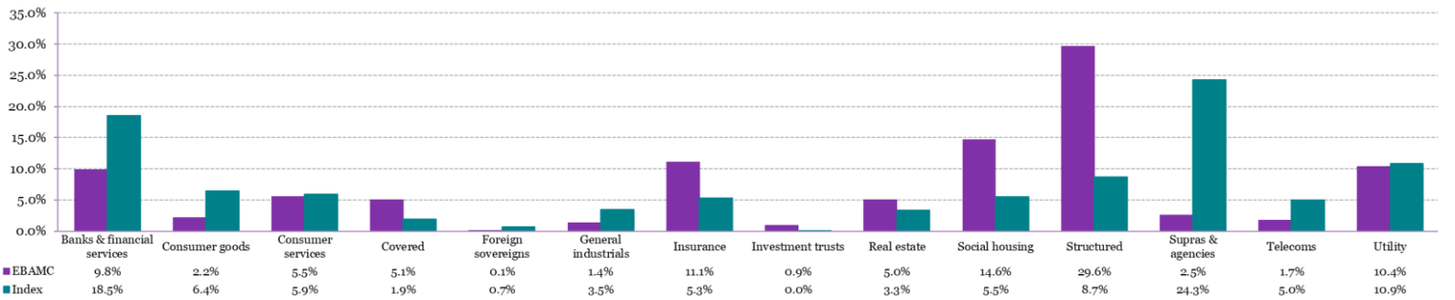
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.
All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.
Source: RLAM, gross of fees.
[1]There is no benchmark for the fund. The index data presented in this report is that of the iBoxx Sterling Non-Gilts All Maturities Index and is for reference purposes only. This index is a broad universe of investment grade sterling credit bonds and is therefore a representative comparison.

Downgrades

Representative portfolio	% downgraded to sub-investment grade
RLPPC Enhanced Buy & Maintain	2.99%
iBoxx Sterling Non-Gilt All Maturities Index	2.90%

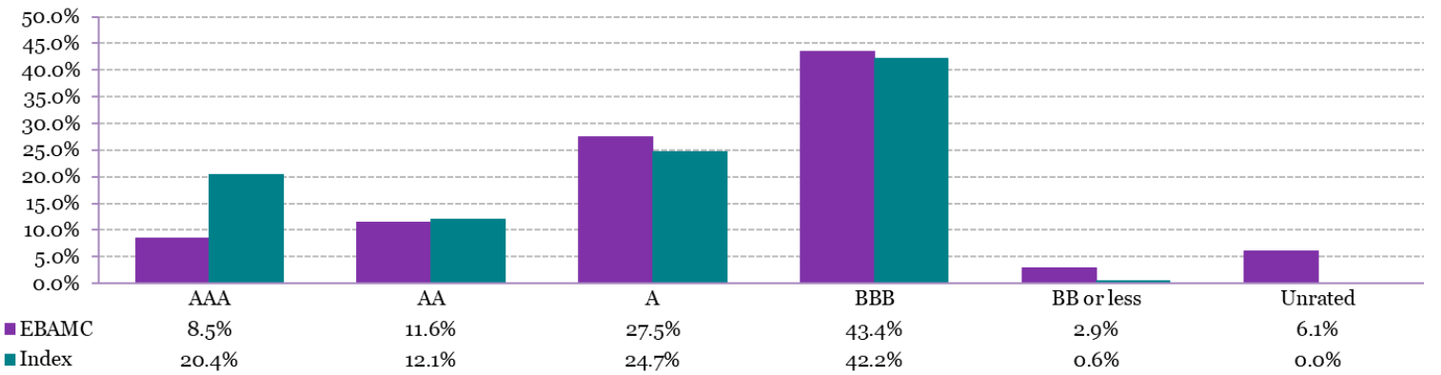
Source: RLAM, showing downgrades since fund inception. Portfolio and benchmark percentages are based on weight prior to downgrade. Worst of Moodys, S&P and Fitch ratings are considered. RLAM internal ratings used in absence of any public ratings. Only first downgrades are included in the table.

Sector breakdown



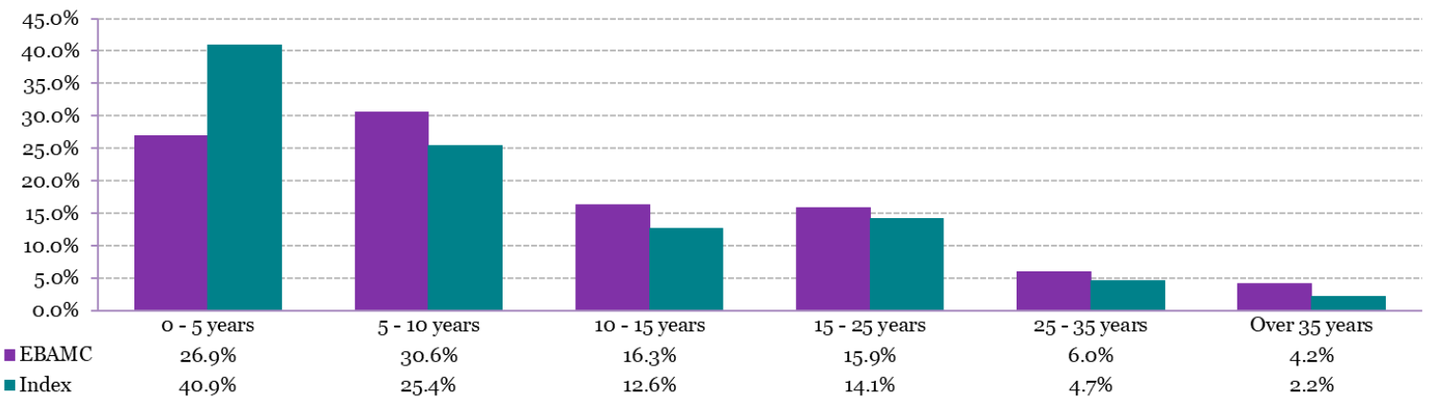
Source: RLAM. Figures in relation to the portfolio exclude the impact of cash held, although they do include the impact of CDs if held within the portfolio.

Rating breakdown



Source: RLAM. Figures in relation to the portfolio exclude the impact of cash held, although they do include the impact of CDs if held within the portfolio.

Maturity profile



Source: RLAM. Figures in relation to the portfolio exclude the impact of cash held, although they do include the impact of CDs if held within the portfolio

Ten largest holdings

	Weighting (%)
Aviva 6.875% 2058	0.9
Flagship Finance Plc 1.875% 2061	0.8
TSB Bank Plc FRN 2028	0.8
The Housing Finance Corporation 5.20% 2043	0.8
HSBC Bank 5.844% VRN Perpetual	0.8
Temasek Financial Ltd 2.75% 2061	0.8
Investec Plc 1.875% 2028	0.7
Clydesdale Bank Plc 4.625% 2026	0.7
British Land Co 5.264% 2035	0.6
Society Of Lloyds 4.875% 2047	0.6
Total	**7.6**

Source: RLAM. Figures in the table above exclude derivatives where held, subject to rounding.

Market overview

- Russia's invasion of Ukraine in late February was met by a unified response from Western powers, enforcing far reaching economic sanctions. Although a sense of calm has returned to markets, the unpredictability of war means that this may not continue.
- After the relatively benign impact of the Omicron variant of Covid-19, central banks globally maintained the hawkish pivot taken into the turn of the year, as they focused on tackling higher than expected inflation rates. Government bonds have been badly impacted by the subsequent rise in interest rate expectations, and the increase to sterling investment grade yields in the period was driven mainly by underlying gilts yields, although spreads have also widened.
- War in Ukraine has exacerbated inflationary pressures. Rising commodity prices are driving up the cost of energy, food, and materials, leading to a further squeeze on real disposable incomes. This is being compounded by higher interest rates, giving rise to concern about future economic growth. Bank of England (BoE) Governor Bailey cited such concerns during the March Monetary Policy Committee (MPC) meeting but increased the interest rate nonetheless; the UK base rate stood at 0.75% at the end of the reporting period, after consecutive 25bps hikes in February and March.
- The UK's Spring Budget Statement saw some measures to limit the impact of forthcoming tax rises, mitigating around one third of impact of rising costs on consumers. Markets are still pricing in seven rate hikes in the UK over the next twelve months, taking the base rate towards 2.5%. In the US, where the economy is better insulated from rising commodity prices (it is a net energy exporter) the Federal Reserve (the Fed) doubled down on its hawkish stance on inflation, highlighting the potential for a diversion in monetary policy between central banks going forward. The Fed ended its quantitative easing (QE) programme at the end of March, as planned, and markets are now pricing eight rate hikes in 2022, which would see the target rate reach around 2.5% by year end.
- In the UK, the benchmark 10-year gilt yield rose from 0.97% to 1.61% in the quarter, a rise of 64bps. There was a respite in the upwards trend following the Russian invasion of Ukraine but concern about inflation and more hawkish central bank rhetoric meant that the fall in yields proved to be temporary. The same pattern was visible in the US and Germany, where yields rose throughout the period but temporarily dipped around the onset of war in Ukraine: in the US, the benchmark 10-year US treasury yield rose from 1.51% to 2.34% in the quarter, while the German 10-year bund yield rose from -0.14% to 0.55%.
- The first quarter of 2022 was the worst performing quarter for sterling credit markets (-6.2%) since the Global Financial Crisis. Although broad sterling credit indices outperformed government bonds this reflected their lower duration, as investment grade spreads widened by 22bps (iBoxx Sterling Non-Gilt index). Defensive sectors such as supranational, covered and asset backed outperformed, whilst financials (banks and insurance) were laggards, particularly subordinated bonds when looking at excess returns (adjusted for the impact of duration). Some energy bonds were weak despite the rise in oil and gas prices, reflecting exposures to Russia. By credit rating, AAA rated debt outperformed other

investment grade ratings bands; BBB rated debt outperformed A rated debt; and sub-investment grade debt outperformed investment grade markets, albeit still delivering negative absolute returns.

Performance

- Sterling credit markets provided negative absolute returns in what was the worse quarter since the Global Financial Crisis. Markets were driven by the significant rise in yields of the underlying gilt market, with nominal gilt yields rising by around 60-70bps across all maturities in the first quarter. Royal London's Buy & Maintain strategy provided negative returns to investors, but outperformed their respective market benchmark.
- The portfolio produced negative returns during the quarter, given the background of significant yield increases in the underlying gilt market, and a modest widening in credit spreads. The nature of buy & maintain investing means that duration is longer than broad credit indices and, therefore, the rise in gilt yields impacted the overall return to a greater extent. From a sector perspective, the limited exposure to supranationals was detrimental, while the sector positions in secured bonds proved to be beneficial. In the latter, the structured student loans bond **ICSL** was a strong performer, demonstrating the value of secured lending in uncertain markets.
- In addition, the portfolio benefitted as a result of having no direct exposure to Russian companies **Gazprom** and **Russian Railways** which both fell out of the benchmark in the period. These bonds represented a small yet material portion of the benchmark. Our indirect exposure to Russian companies was also very limited, as companies in the highest risk sector, financials, had already curtailed exposure to Russia due to requirements around money laundering.

Activity

- In the first two weeks of the quarter sterling credit issuance was extremely strong, helping the market to meet forecast expectations for January even though the latter half of the month proved to be extremely quiet. February was similarly quiet, with the £3.1 billion of issuance in primary sterling markets nearly 50% below estimates. Issuance picked up again in March, as £6.6bn of new debt was brought to market, only a touch below forecasts. Issuance was, however, skewed heavily in favour of financials, particularly non-domestic banks. As ever, activity was driven by reducing holdings where we believe that there has been deterioration in the quality of the credit, or where new issues give us an opportunity to replace holdings with another that offers more attractive spread, lower risk, or both.
- The social housing sector remained a key area of interest. During the quarter we bought a new issue from P**eabody Group**, a housing association based in London which owns and manages more than 67,000 homes across London and the South East. We also added tap issues from **Flagship Finance** and **Blend Funding,** at attractive levels compared with existing bonds. We funded these purchases by reducing our exposure to **Yorkshire Housing**, which we felt was fully valued and where high market demand for A rated bonds created liquidity.
- The portfolio has a material exposure to real estate, where most bonds are backed by significant assets and hence fit well with our preference for secured or strongly covenanted bonds. We bought a new issue from **Prologis investment fund**, who acquire, develop and maintain warehouses across the globe, adding diversification through exposure to non-UK revenues. In the secondary market, we took advantage of rare availability to add to illiquid **British Land** bonds. These offer an attractive above-market yield with attractive backing.
- Utilities are another key area for us – the combination across the sector or regulated industries, infrastructure and long-dated cashflows fit well with this strategy. There were several notable trades in this area during the quarter, including a new issue of a green bond from **Bazalgette**, where proceeds will be used to build-out London's 'super sewer,' delivering extensive environmental benefits. Also in the sector, we bought a new issue from **Northern Powergrid,** continuing our preference for regulated electivity providers.
- Consumer sectors generally see little activity. However, we did see several opportunities here during the quarter, including a new issue from software provider **Sage**. Coming at an attractive spread premium to the market, this is a business that also has significant non-UK revenues. We also added a new issue from **Haleon**, the consumer healthcare business being demerged from GSK and an AA rated new issue from Swiss multinational **Nestle**.

Outlook

- There is considerable uncertainty about the year ahead. The war in Ukraine has worsened existing trends and has given central banks a real dilemma: tighten policy to address inflation or give some slack on further policy moves until the growth consequences become more evident. The US yield curve (between 2- and 10-year maturity bonds) inverted during March, which many view as recession signal.

- In the UK, investors are pricing in a move to a 2.5% base rate over twelve months and in the eurozone there has been a significant shift, with tightening now expected in the second half of the year. Although we expect a slowdown in the medium term, we believe that market pricing may be too aggressive at present. However, we must highlight the uncertainty of any market forecasts at present, given the unpredictability of war in Ukraine.
- The widening in credit spreads has taken valuations to attractive levels, relative to government bonds. However, if tensions in Ukraine intensify, we would expect further modest widening in investment grade and high yield credit spreads. Nevertheless, at current levels, investment grade spreads over-compensate for default risk, and we expect that credit will outperform government debt over the medium term. Our portfolios have a material exposure to BBB bonds but we believe that compensation for default risk remains most attractive for the bonds that we hold in this rating band.
- The Bank of England announced in the quarter that it will sell its holdings of corporate bonds. While the BoE's buy programme had a significant (if only temporary) impact on sterling credit markets, we do not expect the same for the sale. Although the holding is material in size, it is not a structurally significant portion of the market, and with the proposed sales timescale of more than three years, it is unlikely that markets will see enough concentrated activity to generate large swings in pricing.
- We will maintain our long-standing focus on risk management by seeking to identify companies with strong balance sheets; favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers, sectors, and other factors. In addition, we expect to maintain an overweight position in subordinated financial bonds where credit spreads remain attractive.

Find out more

- RLAM recognises that the Ukraine invasion is a human tragedy, and one that we hope is resolved swiftly. As stewards of our investors' assets, we are monitoring the situation closely, and of course are complying with all restrictions and sanctions issued by relevant authorities. RLAM has no exposure to Russian companies in our active funds. We had limited exposure (less than 0.1% of total assets) in our tilt and Emerging Market Tracker funds at the time of the invasion, but subsequently sold every holding we were permitted to. In our Emerging Market Tracker fund, we removed this in line with the MSCI index changes in early March.
- Fund managers and other in-house specialists regularly address the issues that they consider in managing their funds via blogs, articles, webinars and podcasts. Please visit the RLAM Digital Insight Hub, or the *Our Views* section of www.rlam.co.uk for further information.

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